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Research Project:  
A Fraud Survey of Local Governments in South  
Carolina!**

Submitted, Thursday, January 15, 2004

**The South Carolina Certified Public Manager Program (CPM) is a nationally accredited management development program for public managers in South Carolina. The CPM designation is a professional credential that involves intensive study, practice, application, and testing. The Budget and Control Board's Office of Human Resources administers the CPM Program.**

## Introduction

According to Safechecks, embezzlement has been the top-ranked financial crime for more than 30 years. Recent studies indicate that employee embezzlement accounts for the majority of employer losses through employee fraud. The size of the losses is also staggering. In 2003 PricewaterhouseCooper did a global survey and found that the average loss per entity for asset misappropriation in a two-year time period was \$1,388,731.

Even in South Carolina cases of fraud in local government have been on the increase. At Sumter School District 17 the collusion of several employees and outside vendors resulted in the embezzlement of millions of education dollars from our children's future, while South Carolina continues to pridefully hold the title of 49<sup>th</sup> in education.

Occupational fraud and abuse is a widespread problem that affects every organization. Occupational fraud can be defined as: "The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets." It can be as simple as pilferage of company supplies or as complex as sophisticated financial statement frauds. All occupational fraud schemes have three key elements in common. The activity:

- Is held in or conducted with secrecy,
- Violates the perpetrator's fiduciary duties to the victim organization, and
- Costs the employed organization assets, revenue, or reserves.

There are three major types of occupational fraud:

- \*Corruption
- \*Asset Misappropriation
- \*Fraudulent Statements (which include financial statement schemes)

\*Corruption involves fraudsters wrongfully using their influence in a business transaction in order to procure some benefit for themselves or another person, contrary to their employer or the rights of another. It includes the following activities: conflicts of interest, bribery, illegal gratuities, and economic extortion.

\*Asset misappropriation involves the theft or misuse of an organization's assets. It includes larceny, fraudulent disbursements, and skimming of cash, and the misuse and larceny of inventory and all other assets.

\* Fraudulent statements involve falsification of an organization's financial statements. It includes overstating revenues and understating liabilities or expenses. It also includes significant unusual transactions. These significant transactions are outside the normal course of the entity's business or appear unusual.

According to Joseph T. Wells, CFE, CPA, in his book *Occupational Fraud and Abuse*, embezzlement is a special type of fraud: an employee not only steals the assets but that person also violates a fiduciary duty to hold the assets for another where there is trust or a high degree of good faith. To file a charge of embezzlement there must be a relationship such as that of employment or agency between the owner of the money and the defendant. In addition, the money alluded to have been embezzled must have come into the possession of the defendant by virtue of that relationship and there must be an intentional and fraudulent appropriation or conversion of the money.

The elements of embezzlement are as follows:

- The embezzled funds came into possession of the wrongdoer by reason of employment or position of trust;
- Need or greed: unusual financial strains or other motivations creating the mindset to steal;

- Revenge: employees feel wronged, and see employers as unjust, corrupt or discriminatory;
- Thrill seeking: taking the opportunities, employees steal because they can;
- Denial: some employees rationalize their thefts as temporary loans or as entitlements based on past under-compensation; and
- Addiction: dishonest employees often continue to steal until they are caught.

The purpose of this project was to survey local governments in South Carolina about occupational fraud in their organization. The survey was conducted from July 2003 - August 2003. A total of 107 surveys were mailed to local governments. Twenty-six were mailed to cities and town, twenty-five to counties, twenty-five to school districts, and thirty-one to special purpose districts in South Carolina. The intent of this project is that this information may be used as a helpful tool for local governments in South Carolina to prevent occupational fraud.

### Participants

South Carolina has approximately 269 cities and towns; 46 counties; 87 school districts; and 181 registered special purpose districts. South Carolina Act No. 488 defines "special purpose district" as:

"Any district created by an act of General Assembly or pursuant to general law and which provides and local governmental power of function including, but not limited to, fire protection, sewerage treatment, water or natural gas distribution, recreation, and means any rural water district authorized or created under the provisions of Chapter 13, of Title 6."

Out of 107 surveys mailed out only 50 were returned: 11 from cities/towns, 9 from counties, 14 from school districts, and 16 from special purpose district. Out of the 50 surveys returned 44% of local governments indicated that an act of occupational fraud had been committed within their organization in the last fifteen years.

| <b>Fraud Incidents<br/>Summary Results</b> | <b>Fraud<br/>Yes</b> | <b>%</b> | <b>Fraud<br/>No</b> | <b>%</b> | <b>Totals</b> |
|--|----------------------|----------|---------------------|----------|---------------|
| Cities/Towns                               | 5                    | 23%      | 6                   | 21%      | 11            |
| Counties                                   | 4                    | 18%      | 5                   | 18%      | 9             |
| School Districts                           | 9                    | 41%      | 5                   | 18%      | 14            |
| Special Purpose Districts                  | 4                    | 18%      | 12                  | 43%      | 16            |
| Totals                                     | 22                   | 100%     | 28                  | 100%     | 50            |

### Impact of Corporate Scandals

In today's times the mention of the following names may be followed up by an interesting response: Enron, WorldCom, Tyco, Merrill Lynch, Arthur Anderson. The response will usually be "Scandal," "Scandal," and "Scandal." On October 16, 2001, Enron Corporation announced a \$35 million decrease in stated earnings and a \$1.2 billion loss of shareholder equity due to an exclusion of three partnerships from past financial statements. In addition, Enron announced in November 2001 that an additional \$500 million in earnings were overstated. On December 2, 2001, Enron filed for Chapter 11 protection, making it the largest bankruptcy in U.S. history. Enron used accounting tricks, manipulations of the market, and imaginary profits to present itself as the premiere energy trader.

While Enron was one of the largest companies to restate its earnings, it was not the first major corporation to do so. In April 1998, Cendant Corporation, a provider of travel, real estate, vehicle, and financial services, announced that it had inflated its earnings by \$115 million. The next day Cendant's stock dropped by 46 percent. In July,

Cendant issued another restatement, admitting to an additional \$400 million in overstating earnings. Cendant executives and employees pleaded guilty to filing fraudulent financial reports. More importantly, these employees stated that they did so under the explicit orders of company executives.

In June 2002, Tyco International's CEO Dennis Kozlowski was arrested for taking more than \$600 million from his company. In addition, Kozlowski forgave more than \$100 million in loans to company executives for "relocation" costs, which included luxury yachts, extravagant parties, personal artwork, and multimillion-dollar homes. These practices caused investigators to re-examine Tyco's past filings. The end result was a negative restatement of earnings of \$382 million on September 26, 2002. Also in June 2002, Xerox, long viewed as a stable company, revealed \$6.4 billion in overstated earnings. An SEC investigation revealed inflated revenues of \$3 billion. This resulted in a \$10 million fine, which was the largest ever levied by the SEC for financial reporting violations.

These corporate scandals had a dramatic impact on investor confidence. This increasing number of scandals was an indication of a pattern of accounting irregularities. The corporate scandals uncovered many institutional problems within the accounting industry. In 1993, consulting fees made up 31 percent of revenues at the Big Five accounting firms (Arthur Anderson, Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCooper). By 1999, when the corporate scandals began to break, for the first time accounting firms were earning more money from consulting than from audits.

This increasing reliance on consulting within the accounting industry created conflicts of interest between auditing units and consultants. Auditors came under increasing pressure to produce audit reports that supported their firm's consulting advice, to insure a major funding stream for the accounting firms.

### The Cost of Fraud

In August 2002 the Brookings Institution released a policy brief entitled "Cooking the Books: The Cost to the Economy," the brief sought to estimate how much the recent corporate scandals and accounting irregularities contributed to a decline in wealth, and in turn, economic output. The decline caused by the scandals would be part of the larger decline in wealth arising from the financial market's decline from its 2000 peak. Brookings estimated that the corporation scandals reduced GDP by 34% in the first year. It is important to remember that it is impossible to calculate the cost fraud imposes on the economy because not all fraud is detected or reported. In addition, there is no organization charged with accumulating data on fraud offenses, and few studies have been done on the subject.

In their "2002 Report To The Nation, Occupational Fraud and Abuse," from the Association of Certified Fraud Examiners estimates that occupational fraud loss accounted for \$600 billion dollars of the gross domestic product.

## DISTRIBUTION OF DOLLAR LOSSES

Each respondent was asked about the total dollar loss caused by the schemes they reported on. As the following chart illustrates, half of the frauds in the survey cost their victims less than \$10,000.

| Dollar Loss Range<br>/ % of Cases | Cities /<br>Towns | Counties | School<br>Districts | Special Purpose<br>District | Totals | % of<br>Cases |
|-----------------------------------|-------------------|----------|---------------------|-----------------------------|--------|---------------|
| Less than \$10,000                | 2                 | 0        | 5                   | 4                           | 11     | 50%           |
| \$10,000 - \$50,000               | 4                 | 3        | 2                   | 0                           | 9      | 40%           |
| \$50,000 - \$100,000              | 0                 | 1        | 0                   | 0                           | 1      | 5%            |
| Over - \$100,000                  | 0                 | 0        | 1                   | 0                           | 1      | 5%            |
| Totals                            | 6                 | 4        | 8                   | 4                           | 22     | 100%          |

## THE METHODS OF FRAUD

One of the purposes of this report was to determine exactly how fraud is accomplished and to classify the offenses by the methods used to commit them. Each case in the study was reviewed and classified according to the Occupational Fraud Classification System. As mentioned earlier, the three major categories of occupational fraud are asset misappropriations, corruption, and fraudulent statements. Once each scheme was classified, comparisons were made on the costs and frequency of each scheme type.

| Scheme Types               | Cities /<br>Towns | Counties | School<br>Districts | Special<br>Purpose<br>Districts | Totals | % of<br>Cases |
|----------------------------|-------------------|----------|---------------------|---------------------------------|--------|---------------|
| Asset<br>Misappropriations | 5                 | 2        | 7                   | 4                               | 18     | 78%           |
| Corruptions                | 1                 | 2        | 1                   | 0                               | 4      | 18%           |
| Fraudulent<br>Statements   | 0                 | 0        | 1                   | 0                               | 1      | 4%            |
| Totals                     | 6                 | 4        | 9                   | 4                               | 23     | 100%          |



Asset misappropriations were by far the most common of the three schemes, accounting for nearly 80% of the cases reported. Asset misappropriation schemes can be subdivided based on the type of asset that is stolen or misused. Typically, the asset that is most commonly targeted by employees is cash. Almost 100% of the asset misappropriation cases in this report involved the theft of cash. Schemes involving non-cash assets (such as inventory, and equipment) were very unlikely to occur.

Cash schemes can be divided into three categories:

- Fraudulent disbursements, in which the employee causes the organization to disburse funds through some type of skim or device (common examples are submitting false invoices or time sheets),
- Skimming, in which cash is stolen from an organization before it is recorded on the books of the organization, and
- Cash larceny, in which cash is stolen from an organization after it has been recorded on the books of the organization.

Of these three categories, fraudulent disbursements were reported most frequently.

Fraudulent disbursements are comprised of five categories:

- Billing schemes, in which the employee causes the organization to issue a payment by submitting invoices for fictitious goods or services, or invoices for personal purchases,
- Payroll schemes, in which an employee causes the organization to issue a payment by making false claims for compensation,
- Expense reimbursement schemes, in which an employee makes a claim for reimbursement of fictitious or inflated business expenses,
- Check tampering, in which the employee converts the organization's funds by forging or altering a check on one of the organization's bank accounts, or steals a check the organization has legitimately issued to a vendor, and
- Register disbursement schemes, in which an employee makes false entries on a cash register to conceal the fraudulent removal of currency.

## **DURATION OF SCHEMES**

How long does the typical fraud scheme run before it is detected? Based on the surveys received the majority of fraud schemes lasted one year or less. The data indicated that 20% of the schemes lasted one to two years. Based on the data present below there was only one fraud case that lasted over five years.

| <b>Length of Schemes</b> | <b>Cities / Towns</b> | <b>Counties</b> | <b>School Districts</b> | <b>Special Purpose Districts</b> | <b>Totals</b> | <b>% of Cases</b> |
|--------------------------|-----------------------|-----------------|-------------------------|----------------------------------|---------------|-------------------|
| <b>Less than 1 Year</b>  | 3                     | 3               | 5                       | 1                                | 12            | <b>60%</b>        |
| <b>1 to 2 Years</b>      | 2                     | 1               | 1                       | 0                                | 4             | <b>20%</b>        |
| <b>2 to 3 Years</b>      | 0                     | 0               | 1                       | 1                                | 2             | <b>10%</b>        |
| <b>3 to 4 Years</b>      | 0                     | 0               | 0                       | 0                                | 0             | <b>0%</b>         |
| <b>4 to 5 Years</b>      | 1                     | 0               | 0                       | 0                                | 1             | <b>5%</b>         |
| <b>Over 5 Years</b>      | 0                     | 0               | 1                       | 0                                | 1             | <b>5%</b>         |
| <b>Totals</b>            | <b>6</b>              | <b>4</b>        | <b>8</b>                | <b>2</b>                         | <b>20</b>     | <b>100%</b>       |

## **DETECTING & PREVENTING FRAUD**

### **INITIAL DETECTION OF FRAUDS**

One of the obvious ways in dealing with fraud is detecting it soon as possible. Local governments were asked how the frauds they encountered were initially discovered. As the data presents, the most common method of detection was a tip from an employee. This suggests that effective reporting and good, open communication from employees to management can have a position effect on fraud detection.

| <b>Initial Detections</b> | <b>Cities / Towns</b> | <b>Counties</b> | <b>School Districts</b> | <b>Special Purpose Districts</b> | <b>Totals</b> | <b>% of Cases</b> |
|---------------------------|-----------------------|-----------------|-------------------------|----------------------------------|---------------|-------------------|
| <b>By Accident</b>        | 0                     | 0               | 0                       | 1                                | 1             | <b>5%</b>         |
| <b>Tip from employee</b>  | 4                     | 1               | 3                       | 2                                | 10            | <b>45%</b>        |
| <b>Internal Audit</b>     | 2                     | 0               | 3                       | 0                                | 5             | <b>23%</b>        |
| <b>External Audit</b>     | 0                     | 1               | 1                       | 0                                | 2             | <b>9%</b>         |
| <b>Anonymous Tip</b>      | 0                     | 0               | 0                       | 1                                | 1             | <b>5%</b>         |
| <b>Other</b>              | 0                     | 2               | 1                       | 0                                | 3             | <b>13%</b>        |
| <b>Totals</b>             | <b>6</b>              | <b>4</b>        | <b>8</b>                | <b>4</b>                         | <b>22</b>     | <b>100%</b>       |

### **FRAUD PREVENTION MEASURES**

Local governments were asked, based on their own expertise, which measures are most helpful in preventing fraud in their organizations. By far, a strong system of internal controls was viewed as the most effective measure in preventing fraud.

| <b>Prevention Measures</b>   | <b>Cities / Towns</b> | <b>Counties</b> | <b>School Districts</b> | <b>Special Purpose Districts</b> | <b>Totals</b> | <b>% of Cases</b> |
|------------------------------|-----------------------|-----------------|-------------------------|----------------------------------|---------------|-------------------|
| <b>Segregation of Duties</b> | 2                     | 1               | 2                       | 0                                | 5             | <b>27%</b>        |
| <b>Spot Checks</b>           | 1                     | 0               | 0                       | 0                                | 1             | <b>6%</b>         |
| <b>Surprise Audits</b>       | 1                     | 0               | 1                       | 0                                | 2             | <b>11%</b>        |
| <b>Dual Controls</b>         | 0                     | 0               | 2                       | 0                                | 2             | <b>11%</b>        |
| <b>Communications</b>        | 0                     | 1               | 0                       | 0                                | 1             | <b>6%</b>         |
| <b>Internal Controls</b>     | 0                     | 2               | 2                       | 3                                | 7             | <b>39%</b>        |
| <b>Totals</b>                | <b>4</b>              | <b>4</b>        | <b>7</b>                | <b>3</b>                         | <b>18</b>     | <b>100%</b>       |

### **THE PERPETRATORS**

Local governments were asked about the perpetrators who committed the cases of fraud.

The data help profile fraud perpetrators and shows how certain factors affect the size of the losses.

## POSITION OF PERPETRATOR

One of the best indicators of the size of the loss in an occupational fraud scheme is the position of the perpetrator within the organization. Typically, schemes committed by managers and executives cost more. This relationship could be expected, since higher-level employees have a greater degree of control over and access to the organization's assets. The following data show that rank and file employees committed most of the schemes.

| <b>Position of Perpetrator</b> | <b>Cities / Towns</b> | <b>Counties</b> | <b>School Districts</b> | <b>Special Purpose Districts</b> | <b>Totals</b> | <b>% of Cases</b> |
|--------------------------------|-----------------------|-----------------|-------------------------|----------------------------------|---------------|-------------------|
| Chief Financial Officer        | 0                     | 0               | 1                       | 0                                | 1             | 4.5%              |
| Clerk                          | 2                     | 3               | 1                       | 3                                | 9             | 41%               |
| Athletic Director              | 1                     | 0               | 0                       | 0                                | 1             | 4.5%              |
| Supervisory                    | 1                     | 0               | 0                       | 0                                | 1             | 4.5%              |
| Secretary                      | 0                     | 0               | 2                       | 0                                | 2             | 9%                |
| Bookkeeper                     | 0                     | 0               | 3                       | 0                                | 3             | 14%               |
| Director of EMS                | 0                     | 1               | 0                       | 0                                | 1             | 4.5%              |
| Customer Service Rep.          | 0                     | 0               | 0                       | 1                                | 1             | 4.5%              |
| Program Director               | 0                     | 0               | 1                       | 0                                | 1             | 4.5%              |
| Principal                      | 0                     | 0               | 1                       | 0                                | 1             | 4.5%              |
| Mayor                          | 1                     | 0               | 0                       | 0                                | 1             | 4.5%              |
| <b>Totals</b>                  | <b>5</b>              | <b>4</b>        | <b>9</b>                | <b>4</b>                         | <b>22</b>     | <b>100%</b>       |

## GENDER OF PERPETRATOR

| Gender of Perpetrator | Cities / Towns | Counties | School Districts | Special Purpose Districts | Totals    | % of Cases  |
|-----------------------|----------------|----------|------------------|---------------------------|-----------|-------------|
| Male                  | 2              | 4        | 2                | 1                         | 9         | 41%         |
| Female                | 3              | 0        | 7                | 3                         | 13        | 59%         |
| <b>Totals</b>         | <b>5</b>       | <b>4</b> | <b>9</b>         | <b>4</b>                  | <b>22</b> | <b>100%</b> |

The gender data point out some interesting information. The higher number of female perpetrators in the school districts is simply a reflection of fact that most teachers are females. The most interesting bit of information has to do with the fact that 100% of the perpetrators were male from the counties. That could be a reflection of South Carolina government and politics. Because of South Carolina's conservative politics, county governments are still dominated by males with the old aristocrat mentality.

## AGE OF PERPETRATOR

| Age of Perpetrator | Cities / Towns | Counties | School Districts | Special Purpose Districts | Totals    | % of Cases  |
|--------------------|----------------|----------|------------------|---------------------------|-----------|-------------|
| 18 to 25 Years Old | 1              | 0        | 1                | 1                         | 3         | 15%         |
| 26 to 35 Years Old | 0              | 1        | 3                | 0                         | 4         | 20%         |
| 36 to 45 Years Old | 1              | 1        | 0                | 3                         | 5         | 25%         |
| 46 to 55 Years Old | 0              | 2        | 3                | 0                         | 5         | 25%         |
| Over 56 Years Old  | 3              | 0        | 0                | 0                         | 3         | 15%         |
| <b>Totals</b>      | <b>5</b>       | <b>4</b> | <b>7</b>         | <b>4</b>                  | <b>20</b> | <b>100%</b> |

Some studies have suggested that younger employees commit most of the occupational crimes; these data do not support that point of view. The data show that the age of the perpetrator is evenly distributed over the young and old. Because older employees tend to occupy senior positions and have more access to assets there is a greater loss per case.

## LEVEL OF EDUCATION

| <b>Level of Education of Perpetrator</b> | <b>Cities / Towns</b> | <b>Counties</b> | <b>School Districts</b> | <b>Special Purpose Districts</b> | <b>Totals</b> | <b>% of Cases</b> |
|--|-----------------------|-----------------|-------------------------|----------------------------------|---------------|-------------------|
| High School Diploma                      | 2                     | 2               | 5                       | 2                                | 11            | 58%               |
| Associate's Degree                       | 0                     | 0               | 0                       | 2                                | 2             | 10%               |
| Bachelor's Degree                        | 1                     | 2               | 1                       | 0                                | 4             | 21%               |
| Master's Degree                          | 0                     | 0               | 2                       | 0                                | 2             | 11%               |
| Master's Plus                            | 0                     | 0               | 0                       | 0                                | 0             | 0%                |
| <b>Totals</b>                            | <b>3</b>              | <b>4</b>        | <b>8</b>                | <b>4</b>                         | <b>19</b>     | <b>100%</b>       |

Studies have shown that in general there is a link between higher levels of education and the amount of the loss.

## CONVICTION STATUS OF PERPETRATOR

The following chart shows that only a little over half of the perpetrators were charged and prosecuted for their crimes. The data show that school districts prosecuted more often than any other local government entity in South Carolina. In contrast cities and towns were least likely to prosecute for fraud. One possible explanation for this is that cities and towns tend to be political animals more than school districts. In addition, there is probably more public support for prosecuting individuals who might be taking away funds from children.

| <b>Conviction Status of Perpetrator</b> | <b>Cities / Towns</b> | <b>Counties</b> | <b>School Districts</b> | <b>Special Purpose Districts</b> | <b>Totals</b> | <b>% of Cases</b> |
|---|-----------------------|-----------------|-------------------------|----------------------------------|---------------|-------------------|
| Yes                                     | 1                     | 3               | 7                       | 1                                | 12            | 55%               |
| No                                      | 4                     | 1               | 2                       | 3                                | 10            | 45%               |
| <b>Totals</b>                           | <b>5</b>              | <b>4</b>        | <b>9</b>                | <b>4</b>                         | <b>22</b>     | <b>100%</b>       |

## NO LEGAL ACTION

Local governments were also asked if the perpetrator was not charged, why not?

| Why not charged?    | Cities / Towns | Counties | School Districts | Special Purpose Districts | Totals    | % of Cases  |
|---------------------|----------------|----------|------------------|---------------------------|-----------|-------------|
| Immaterial          | 2              | 1        | 1                | 1                         | 5         | 50%         |
| Not enough evidence | 1              | 0        | 1                | 2                         | 4         | 40%         |
| Board decision      | 1              | 0        | 0                | 0                         | 1         | 10%         |
| <b>Totals</b>       | <b>4</b>       | <b>1</b> | <b>2</b>         | <b>3</b>                  | <b>10</b> | <b>100%</b> |

## ANTI-FRAUD MEASURES

Local governments were asked about controls that existed within their organizations.

We asked if the fraud schemes succeed because of a lack of controls?

| Preventative Controls? | Cities / Towns | Counties | School Districts | Special Purpose Districts | Totals    | % of Cases  |
|------------------------|----------------|----------|------------------|---------------------------|-----------|-------------|
| Yes                    | 1              | 2        | 5                | 3                         | 11        | 52%         |
| No                     | 4              | 2        | 3                | 1                         | 10        | 48%         |
| <b>Totals</b>          | <b>5</b>       | <b>4</b> | <b>8</b>         | <b>4</b>                  | <b>21</b> | <b>100%</b> |

If no, did they succeed because preventive controls were ignored?

| Were controls ignored? | Cities / Towns | Counties | School Districts | Special Purpose Districts | Totals    | % of Cases  |
|------------------------|----------------|----------|------------------|---------------------------|-----------|-------------|
| Yes                    | 4              | 2        | 3                | 0                         | 9         | 90%         |
| No                     | 0              | 0        | 0                | 1                         | 1         | 10%         |
| <b>Totals</b>          | <b>4</b>       | <b>2</b> | <b>3</b>         | <b>1</b>                  | <b>10</b> | <b>100%</b> |

## POST-FRAUD REACTIONS

Was the organization able to recover any of the losses?

| Losses Recovered? | Cities / Towns | Counties | School Districts | Special Purpose Districts | Totals    | % of Cases  |
|-------------------|----------------|----------|------------------|---------------------------|-----------|-------------|
| Yes               | 4              | 3        | 6                | 3                         | 16        | 73%         |
| No                | 1              | 1        | 3                | 1                         | 6         | 27%         |
| <b>Totals</b>     | <b>5</b>       | <b>4</b> | <b>9</b>         | <b>4</b>                  | <b>22</b> | <b>100%</b> |

Local governments were also asked if the organization was not able to recovery any of the losses, why not? Two of the school districts stated there was not enough proof and one county stated that it was not worth it.

## ASSET MISAPPROPRIATION

Based on my survey of local governments, 85% of the incidents involved asset misappropriation. Because I would like for this report to be a tool for local governments to prevent occupational fraud, I will discuss asset misappropriation in more detail and ways to prevent it. There are three major categories of asset misappropriation schemes: cash receipts, fraudulent disbursements of cash, and theft of inventory and other non-cash assets.

### Cash Receipts

Cash is the focal point of most accounting entries. Cash schemes can either be on-book or off-book, depending on where they occur. Cash receipts schemes fall into two categories: skimming and larceny. Skimming is the theft of cash that has not yet been recorded on the books, while larceny is the theft of cash that has already appeared on an organization's books.



## Skimming

Skimming is one of the most common forms of occupational fraud. Because skimming is known as "off-book" fraud these schemes typically leave no direct audit trail. Off-book means that the funds are never recorded with the possibility the victim organization may not be aware that the cash was ever received.

Sales skimming is the most basic skimming scheme. It occurs when an employee sells goods or services to a customer, collects the customer's payment, but makes no record of the sale. The employee pockets the money received and never turns it over to his or her employer. One form of sales skimming is register manipulation. Register manipulation involves an employee ringing a "no sale" or other non-cash transaction to cover up the theft. The false transaction is entered on the register so that it appears a sale is being rung up. The perpetrator opens the register drawer and pretends to place the cash he or she has just received in the drawer, but pockets the cash instead.

Another form of skimming is theft of checks received through the mail. Checks received through the mail are a frequent target of employees seeking illegal gains. Theft of incoming checks usually occurs when one employee is in charge of opening the mail and recording the receipt of payments. This employee simply steals one or more incoming checks and never posts them to the customers' accounts.

### Example

A mailroom employee stole over \$2 million in government checks arriving through the mail. This employee simply identified and removed envelopes delivered from a government agency known to send checks to the company. Using a group of accomplices acting under the names of fictitious persons and companies, this individual was able to launder the checks. [Joseph T. Wells, *Occupational Fraud and Abuse*, (Obsidian, 1997).]

The final skimming scheme I would like to discuss is check for currency substitutions. Because of obvious reasons intelligent criminals prefer to steal currency rather than checks. Currency is harder to trace than a check, a cashed check will be returned to the person who wrote it, and a check is difficult to convert into cash. To avoid these complications criminals who steal unrecorded checks will frequently substitute them for receipted currency. For example, if an employee skims a check worth \$200, he or she can add the check to the day's receipts and remove \$200 in currency. The total receipts for the day will match the amount of cash on hand, but payments in currency are replaced by the check.

#### Example

An employee responsible for receipting ticket and fine payments on behalf of a municipality stole incoming revenue for nearly two years. When this individual received payments in currency, she issued receipts, but when checks were received she did not. The check payments were therefore unrecorded revenue, perfect for skimming. These unrecorded checks were placed in the day's receipts and an equal amount of cash was removed. The receipts matched the amount of money on hand except that payments in currency had been replaced with checks. [Joseph T. Wells, *Occupational Fraud and Abuse*, (Obsidian, 1997)]

Lapping is one of the most common schemes of receivable skimming. Lapping has also been called the "robbing Peter to pay Paul" scheme. It is the crediting of one account through fake payments from another account. Suppose an organization has three customers, A, B, and C. When A's payment is received, the perpetrator steals it instead of posting it to A's account. Customer A expects that his or her account will be credited with the payment made. If the payment has not been posted by the time A's next statement is mailed, he or she will see that the payment was not applied to his account and will certainly complain.

To avoid this, the perpetrator must take some action to make it appear that the payment has been posted. When B's check is received, the perpetrator posts this payment to A's account. Payments now appear to be up-to-date on A's account, but B's account is now behind. When C's payment is received, the perpetrator applies it to B's account. Unfortunately, this process continues indefinitely until one of three things happens: (1) someone discovers the scheme, (2) restitution is made to the accounts, or (3) some concealing entry is made to adjust the accounts receivable balances.

#### Example

A clerk working for a government agency committed a lapping scheme that involved the theft of more than 150 customer payments, causing a total misappropriation of more than \$30,000 in government funds. This perpetrator stole taxes, fees and other incoming payments from customers to cover his personal expenses. When a customer's payment was stolen, the documentation on that payment would be hidden until a later payment was received. The later payment would be applied to the earlier customer's records. As the rotating schedule of applying and misapplying payments became more and more complicated, the perpetrator insisted on exerting more and more control over the receipting process. He insisted on handling all incoming mail, preparing the deposit and delivering the deposit to the bank so that he could continue to delay the posting of payments. The fraud was detected in large part because several customers complained that they had not received confirmation of their payments, even though their checks had cleared months earlier. [Joseph T. Wells, *Occupational Fraud and Abuse*, (Obsidian, 1997).]

#### Prevention of Skimming Schemes

Internal control procedures are the keys to preventing skimming schemes. An essential part of developing control procedures is management's communication to employees. Sales entries and general ledger access controls should include documented policies and procedures.

Other general controls include:

- Appropriate segregation of duties and access control procedures regarding who makes ledger transactions will be followed,
- Transactions must be properly recorded as to amount, date of occurrence, and ledger account, and
- Proper safeguard measures must be adopted to protect physical access to the account systems and assets of the organization.

### **Skimming Controls**

Here are some audit program questions that may be red flags:

- Does someone independent of the cashier, accounts receivable clerk, or other accounting employees who may initiate or post journal entries open mail?
- Does the employee who opens the mail:
  - Place restrictive endorsements ("For Deposit Only") on all checks received?
  - Prepare a list of the money, checks, and other receipts?
  - Forward all remittances to the person responsible for preparing and making the daily bank deposit?
- Is a lock box used?
- Do cash sales occur? If yes:
  - Are cash receipts pre-numbered?
  - Is an independent check of pre-numbered receipts done daily and reconciled to cash collections?
- Do cash refunds require approval?
- Are cash receipts deposited intact daily?
- Are employees who handle receipts bonded?
- Is the accounts receivable bookkeeper restricted from:
  - Preparing the bank deposit?
  - Obtaining access to the cash receipts book?
  - Having access to collections from customers?
- Is the cashier restricted from gaining access to the accounts receivable records and bank and customer statements?
- Are safeguard in place in areas where cash is handled physically?
- Is the person who makes postings to the general ledger independent of the cash receipts and accounts receivable functions?

## **Larceny**

Cash larceny is defined as the intentional taking of an employer's cash (including both currency and checks) without the consent of the employer. Because every company must deal with the receipt, deposit, and distribution of cash, the vulnerability to a cash larceny scheme is great.

Obviously, most cash larceny schemes occur at the cash register. The high activity level at the register and the possibility that there may be several employees handling cash can serve as a cover for the theft. In a larceny scheme the funds that the perpetrator steals have already been reflected on the register tape.

## **Detection of Cash Larceny**

Cash receipts and recording process analysis is the key to detecting a cash larceny scheme. Areas of analysis may include:

- Mail and register receipt points
- Journalizing and recording of the receipts
- The security of the cash from receipt to deposit

## **Prevention of Cash Larceny**

The primary prevention of cash larceny is segregation of duties. It is inappropriate for one person to have control over the entire accounting process (e.g. authorization, recording, and custody).

Each of the following duties and responsibilities should ideally be segregated:

- Cash receipts
- Cash counts
- Bank deposits
- Deposit receipt reconciliation
- Bank reconciliation
- Posting of deposits
- Cash disbursements

Many fraud schemes are continuous in nature and require ongoing efforts by the employee to conceal it. Mandatory job rotation is an excellent method of detecting cash fraud. By establishing a mandatory job or assignment rotation, the concealment element is interrupted. Mandatory vacations are also a good tool in preventing larceny. It is very important that during the employee's absence, another individual perform the normal workload of that employee. The purpose of mandatory vacations is lost if the work is allowed to remain undone during the employee's time off. Finally, surprise cash counts are very useful in fraud prevention. It is important that employees know that cash will be counted on an unscheduled basis.

### **Fraudulent Disbursement**

Fraudulent disbursement involves an employee making a distribution of company funds for a dishonest purpose. Examples of fraudulent disbursements include forging checks, the submission of false invoices, falsifying timecards, and setting up fictitious vendors. One important thing to point out is that on their face, fraudulent disbursements do not appear any different from valid disbursements.

For instance, when an employee runs a bogus invoice through the accounts payable system, the victim organization cuts a check for the bad invoice right along with all the legitimate payments it makes. Some frauds are based on the amount, recipient, or destination of the payment, but the method of payment is legitimate.

### **Fictitious Refunds**

This is especially important for local governments who collect business license fees. It is very common for refunds to be issued for overpayments because for the initial year the fee is based on an estimate of gross receipts. Another area of fraudulent refunds is credit card fraud. When purchases are made with a credit card rather than cash, refunds appear as credits to the customer's credit card rather than as cash disbursements. Dishonest employees process false refunds on credit card sales in lieu of processing a normal cash transaction. One benefit of the credit card method is that the perpetrator does not have to physically take cash from the register and carry it out of the store.

In a typical credit card refund scheme, the perpetrator rings up a refund on a credit card sale, even though the merchandise is not actually being returned. The employee then credits his or her own credit card number rather than the customer's. The result is that the cost of the item is credited to the perpetrator's credit card account.

Other credit card refund schemes involve perpetrators processing refunds to the accounts of other people, and receiving a portion of the refund as a kickback. For example, a person needs \$100. That person goes to the store where a friend is a teller and the teller processes a credit of \$150 to his or her account.

The “customer” then goes to an ATM machine and withdraws the \$150. He or she pays \$50 to the teller and keeps the \$100.

### **Authorized Maker Schemes**

The most basic way an employee accomplishes an authorized maker scheme is to override controls designed to prevent fraud. Most authorized signatories have high levels of influence within their companies. Usually, the perpetrators will use their influence to deflect questions about fraudulent transactions. Authorized maker schemes involve majority owners or sole shareholders using their company to pay personal expenses directly out of company accounts. Or the perpetrator might cut checks directly to himself, herself, his or her friend, or family. Using fear of job security as a weapon, the owner can maintain a work environment in which employees are afraid to question these transactions.

### **Check Tampering Red Flags**

The following signs may indicate fraud:

- Voided checks may indicate employees have embezzled cash and charged the embezzlement to expense accounts. When the expense is paid (from accounts payable), fraudulent checks are marked and entered as void and removed from the list of outstanding checks. An account balancing journal entry is then made. The list of voided checks should be verified against physical copies of the checks. Bank statements should be reviewed to ensure that voided checks have not been processed.
- Missing checks may indicate lax control over the physical safekeeping of checks. Stop payments should be issued for all missing checks.
- Checks payable to employees, with the exception of regular payroll checks, should be reviewed closely. Such an examination may indicate other schemes such as conflicts of interest, fictitious vendors, or duplicate expense reimbursements.
- Altered endorsements or dual endorsements of returned checks may indicate possible tampering.



### **Major Compromises in the Accounts Payable System:**

- Lack of segregation of duties for personnel in the accounting and data processing functions is at the heart of most cash disbursement fraud cases.
- Employees and outside vendors, with help from accounts payable workers, cause compromises in the accounts payable system.
- Employees with too many duties are able to compromise the entity's internal controls in the accounts payable system.

### **Payroll Fraud**

In payroll schemes, perpetrators falsify timesheets and alter information in the payroll records. The most common payroll schemes are the ghost employee schemes, falsified hours and salary schemes, and sales commission schemes. The ghost employee refers to someone on the payroll who does not actually work for the victim organization. Through the falsification of personnel or payroll records a fraudster causes paychecks to be generated to a ghost. The following four things must happen in order for a ghost employee scheme to work: 1) the ghost must be added to the payroll system; 2) timekeeping and wage rate information must be collected; 3) a paycheck must be issued to the ghost; and 4) the check must be delivered to the perpetrator or an accomplice.

#### **Example**

A manager who was responsible for hiring and scheduling janitorial work added over 80 ghost employees to his payroll. The ghosts in this case were actual people who worked at other jobs for different companies. The manager filled out time sheets for the fictitious employees and authorized them, then took the resulting paychecks to the ghost employees, who cashed them and split the proceeds with the manager. It was this manager's authority in the hiring and supervision of employees that enabled him to perpetrate this fraud. [Joseph T. Wells, Occupational Fraud and Abuse, (Obsidian, 1997).]

### Example

An employee in the payroll department was given the authority to enter new employees into the payroll system, make corrections to payroll information, and distribute paychecks. This employee's manager gave rubber stamp approval to the employee's actions because of a trusting relationship between the two. The lack of separation of duties and the absence of review made it simple for the culprit to add a fictitious employee into the payroll system. [Joseph T. Wells, Occupational Fraud and Abuse, (Obsidian, 1997).]

### Detection of Payroll Schemes:

- Independent Payroll Distribution – Having personnel (other than the payroll department) distribute the payroll checks, and require positive identification of the payee.
- Analysis of Payee Address or Accounts – Search for duplicate addresses or deposit accounts.
- Duplicate Identification Numbers – Search for duplicate social security numbers.
- Overtime Authorization – Require employees to have overtime authorized by a supervisor, have the supervisor be responsible for the timesheet, and have the supervisor refer the timesheet directly to payroll.
- Analysis of Deductions from Payroll Checks – Review payroll withholdings; ghost employees often will have no withholding taxes, insurance, or other normal deductions.

### Prevention of Payroll Schemes

There are two basic prevention measures for payroll related fraud: segregation of duties and periodic payroll review and analysis. The following duties should be segregated:

- Payroll preparation
- Payroll disbursement (into payroll and withholding tax accounts)
- Payroll distribution
- Payroll bank reconciliation
- Human resources departmental functions

## **Why Does Fraud Occur?**

One theory suggests that people engage in fraudulent activity as a result of an interaction of forces both within an individual's personality and the external environment. These forces are divided into three major categories:

- Situational Pressures
- Available Opportunities
- Personal Characteristics (Integrity)

Typically, a person with a high level of personal integrity and limited opportunity or pressure to commit fraud is most likely to behave honestly. In contrast, an individual with less personal integrity, when placed in situations with increasing pressure and opportunities, is more likely to commit fraud.

### **Red-flag Check List To Detect Possible Fraudulent Activity:**

- Do any of your employees have unusually high personal debt?
- Do any of your employees appear to be living beyond their means?
- Do any of your employees engage in habitual gambling?
- Do any of your employees appear to abuse alcohol or drugs?
- Do any of your employees appear to lack personal codes of ethics?
- Do any of your employees appear to be unstable (e.g., have frequent job or residence changes or mental or emotional problems)?
- Is your entity experiencing a tight budget?
- Does your organization use several different banks?
- Do any employees have close associations with suppliers?
- Is the organization experiencing a rapid turnover of key employees, either through quitting or being fired?
- Is the organization dominated by one or two individuals?

## **Conclusion**

Occupational fraud is one of the most serious problems facing local governments in South Carolina. While the rate of occupational fraud is difficult to measure, evidence suggests that the incidents are vastly underreported. Cash is obviously the asset most targeted by perpetrators. Organizations are most vulnerable when cash is collected and when it is disbursed. Therefore, proper oversight of the revenue and disbursement cycle is the key to controlling cash fraud.

Internal controls are the best deterrent to occupational fraud. The following minimum procedures are recommended for organizations: do not allow the same employee to keep books, collect funds, write checks, and reconcile the bank account; have the monthly bank statement delivered unopened to the finance director, who should review it for unusual transactions; and consider an annual independent review of internal controls.

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## Appendix A

### PUBLIC SECTOR FRAUD SURVEY

I am a candidate in the South Carolina Certified Public Manager's Program (CPM). I am conducting an occupational fraud survey focusing on local governments in South Carolina.

The term "occupational fraud" may be defined as: "The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets.

Please take a few moments to complete the survey.

1. Has a case of occupational fraud occurred within the last 15 years in your entity?
2. What was the cost of the fraud detected or reported?
3. Please classify the occupational fraud into one of the following categories:
  - \* **Asset misappropriations**, which involve the theft or misuse of an organization's assets. (Common examples include skimming revenues, stealing inventory, and payroll fraud.)
  - \* **Corruption**, in which fraudsters wrongfully use their influence in a business transaction in order to procure some benefit for themselves or another person, contrary to their employer or the rights of another. (Common examples include accepting kickbacks and engaging in conflicts of interest.)
  - \* **Fraudulent statements**, with generally involve falsification of an organization's financial statements. (Common examples include overstating revenues and understating liabilities or expenses.)
4. How long did the fraud scheme run before it was detected?
5. How was the fraud detecting (by accident, tip from employee, internal audit, external audit, or anonymous tip)?

6. Based on your experience which measures are most helpful in preventing fraud in your organization?
7. What position did the perpetrator hold within the organization?
8. What was the gender of the perpetrator?
9. What was the age of the perpetrator?
10. What was the level of education of the perpetrator?
11. Was the perpetrator charged and prosecuted? If not, why?
12. In your organization did the fraud schemes succeed because of a lack of controls or did they succeed because preventive controls were ignored?
13. Was the organization able to recovery any of the losses?